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In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 73-1701

UNITED STATES OF AMERICA, APPELLANT

v.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., ET AL.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLUMBIA

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

OPINION BELOW

The opinion of the district court (J.S. App. A, 29-68), accompanying its order of dismissal (J.S. App. B, 69-70), is reported at 374 F. Supp. 95.

JURISDICTION

The memorandum opinion and order of the district court were entered on December 14, 1973. The notice of appeal to this Court (J.S. App. C, 71) was filed on February 11, 1974. On March 14, 1974, the Chief Justice extended the time for docketing the appeal to May 13, 1974, and the appeal was docketed on that

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date. Probable jurisdiction was noted on October 15, 1974. The jurisdiction of this Court is conferred by Section 2 of the Expediting Act, 15 U.S.C. 29.

QUESTION PRESENTED

This case involves several unique characteristics of mutual funds which underlie the scheme of regulation of the distribution and marketing of mutual fund shares contained in Section 22 of the Investment Company Act. These include the following:[1]

1. Mutual funds stand ready to redeem their outstanding shares upon request of the shareholder at any time. It is possible to do this on an equitable basis because the assets of mutual funds consist almost entirely of marketable securities and cash; and, therefore, the value of mutual fund shares may be computed at any time by adding up the market value of the portfolio shares plus cash and dividing this by the number of outstanding shares. The resulting figure is usually referred to as the "net asset value."

2. As a result of the redeemability feature, mutual funds must continuously sell new shares in order to avoid the slow forced liquidation of the fund because of redemptions.

3. If a mutual fund were to sell new shares for a price, after selling commissions, which is less than the net asset value or were to redeem outstanding shares at a price in excess of the net asset value, the equity of existing shareholders would be unfairly diluted. In order to avoid this, Section 22 of the Investment Company Act and the rules thereunder require that the net asset value

[1] The characteristics of mutual funds enumerated in this paragraph are fully substantiated in the subsequent text.

be computed at least daily and in effect prohibit sales netting the fund less than that amount, or redemptions at prices above that amount.

4. By reason of the foregoing, the forces of supply and demand do not affect the price of mutual funds in the same way in which they affect the market value of other securities. There is an almost unlimited supply of new shares available at net asset value, plus selling commissions, and in the normal case no shares are available at a price below net asset value, since existing shareholders can always obtain net asset value by tendering their shares for redemption.

The Commission will discuss the following question:

Whether in the framework of the pervasive scheme of Securities and Exchange Commission regulation of mutual fund activities, established by the Investment Company Act of 1940 and the Maloney Act amendments to the Securities Exchange Act of 1934 ("Maloney Act"), a mutual fund, its underwriters and its dealers who have contracted with the underwriter to distribute the fund's shares ("contract-dealers") may lawfully agree, pursuant to Section 22(f) of the Investment Company Act,

1. to restrict the terms under which the underwriter and contract-dealers will conduct transactions with noncontract-dealers in the fund's shares ("inter-dealer transactions"); and
2. to exclude participation of contract-dealers as agents in sales of previously-issued fund shares by public investors ("brokerage transactions") which do not occur at the public offering price of the fund's shares, as stated in the fund's prospectus;

so long as such agreements are filed with the Commission as part of the fund's registration statement and are not in contravention of rules of the Commission adopted pursuant to Section 22(f).

STATUTES INVOLVED

Sections 22 (d) and (f) of the Investment Company Act of 1940, 54 Stat. 824, as amended, 15 U.S.C. 80a-22 (d) and (f), provide in pertinent part:

> (d) No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, except at a current public offering price described in the prospectus
>
> * * * * *
>
> (f) No registered open-end company shall restrict the transferability or negotiability of any security of which it is the issuer except in conformity with the statements with respect thereto contained in its registration statement nor in contravention of such rules and regulations as the Commission may prescribe in the interests of the holders of all of the outstanding securities of such investment company.

Section 15A of the Securities Exchange Act, 15 U.S.C. 78*o*-3, which was added to the Exchange Act

through the 1938 Maloney Act Amendments, Public Law No. 719, 75th Cong. (52 Stat. 1070) is generally relevant to this lawsuit. Specific sections of the Maloney Act are discussed at pages 11 through 12 *infra.*

Section 1 of the Sherman Act, 26 Stat. 209, as amended, 15 U.S.C. 1, provides in pertinent part:

> Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal * * *.

STATEMENT

In this civil action under Section 4 of the Sherman Act, 15 U.S.C. 4, the United States seeks injunctive relief against the National Association of Securities Dealers, Inc. ("NASD"), certain open-end management investment companies ("mutual funds"),[2] mutual fund underwriters,[3] and securities broker-deal-

[2] Massachusetts Investors Growth Stock Fund, Inc.; Fidelity Fund, Inc.; and Wellington Fund, Inc. The Investment Company Act defines an open-end management investment company to be any issuer which (1) "is or holds itself out as being primarily * * * in the business of investing, reinvesting or trading in securities" (15 U.S.C. 80a-3); (2) is not a face-amount certificate company or a unit investment trust (15 U.S.C. 80a-4); and (3) is "offering for sale or has outstanding any redeemable security of which it is the issuer" (15 U.S.C. 80a-5).

[3] The Crosby Corporation; Vance, Sanders & Co., Inc.; and The Wellington Management Company, Inc. Section 2(a)(40) of the Investment Company Act defines Underwriter as a person who purchases shares from an issuer with a view to distribution or sells for an issuer in connection with a distribution of the issuer's shares (15 U.S.C. 80a-2(a)(40)).

ers,[4] for alleged violations of Section 1 of that Act. The complaint generally alleges that the defendants

> * * * combined and agreed to restrict the sale and fix the resale prices of the shares of open-end mutual funds in "secondary market" transactions between dealers, or from an investor to a dealer (collectively the "secondary dealer" or "interdealer" market), and between investors through a broker (the "brokerage market").

The district court, holding that the defendants' conduct was immunized from antitrust attack by the "pervasive regulatory scheme" established in Section 22 of the Investment Company Act, 15 U.S.C. 80a-22, and the Maloney Act Amendments to the Securities Exchange Act, 15 U.S.C. 78*o*-3, over the "narrow area of distribution and sales of mutual fund shares," granted the defendants' motions to dismiss the complaint "on the merits and with prejudice for failure to state a claim upon which relief can be granted." 374 F. Supp. at 114.

A. THE REGULATION OF MUTUAL FUNDS

As Chairman Garrett of the Commission recently had occasion to note "[n]o issuer of securities is sub-

[4] Merrill Lynch, Pierce, Fenner & Smith, Inc.; Bache & Company, Inc.; Reynolds Securities Corp.; E. I. duPont, Glore Forgan, Inc.; E. F. Hutton, Inc.; Walston & Company, Inc.; Dean Witter & Company, Inc.; Paine, Webber, Jackson & Curtis, Inc.; and Hornblower & Weeks—Hemphill, Noyes, Inc. Section 2(a)(11) of the Investment Company Act defines Dealer as a person who buys and sells securities for his own account (15 U.S.C. 80a-2(a)(11)). Section 2(a)(6) of the Act defines Broker as a person who effects transactions in securities for the account of others (15 U.S.C. 80a-2(a)(6)).

ject to more detailed regulation than a mutual fund."[5] Regulation of mutual funds is generally accomplished through the Investment Company Act of 1940. Thus, the Court below explained that:

> * * * pursuant to the 1940 Act [mutual funds and other] investment companies must register themselves (§§ 7 and 8) and their shares [§ 24 (a)] with the SEC, update periodically their filings with quarterly and annual reports [§§ 30 (a)-(c)], and submit prospectuses and sales literature to the SEC [§ 24(b)]. Companies must issue to their shareholders, at least semiannually, financial reports containing specific types of information [§ 30(d)].
>
> The 1940 Act also imposes detailed restrictions upon investment company structure, conduct, financial policies, and dealings with and by affiliates.[12]
>
> [12] The Act delimits permissible methods for selecting directors of investment companies (and trustees in the case of investment trusts) (§ 16) sets out qualifications for securities custodians [§ 17(i)] and methods of safekeeping securities [§ 17(g)], and prohibits indemnification for official conduct [§§ 17(h) and (i)]. Certain persons guilty of prior malfeasance are barred altogether

[5] Letter from Ray Garrett, Jr., Chairman, Securities and Exchange Commission to the Honorable John Sparkman, Chairman of the Committee on Banking, Housing and Urban Affairs, United States Senate (dated Nov. 4, 1974) ("Chairman Garrett letter") forwarding Report of the Division of Investment Management Regulation, *Mutual Fund Distribution and Section 22(d) of the Investment Company Act of 1940* (August, 1974) ("Staff Report"). This report, which is discussed in greater detail *infra* at 21–26, 55–57, sets forth a wide ranging program for modification of the mutual fund distribution system including the orderly introduction of retail price competition, through the exercise of existing Commission regulatory authority, and through proposed legislative action.

from affiliating with investment companies, advisers, custodians, and principal underwriters (§ 9). Others who commit misconduct or abuse their positions of trust can be enjoined (§ 36). Misappropriation of company funds is made a federal crime (§ 37).

The Act also sets out minimum capitalization requirements for the companies (§§ 14 and 18). It requires a majority shareholder vote for changes in a company's open-end or closed-end nature, its diversification, its capacity to borrow money, issue senior securities, underwrite others' securities, purchase and sell real estate and commodities, or make loans, its investment policies, and its fundamental business (§ 13). Certain dividend distributions are barred unless timely disclosed to the shareholders [and the frequency of other distributions is limited] (§ 19). Investment companies are barred from participating in certain types of securities transactions [12(a)] and from making certain loans (§ 21). Some proxy solicitations are barred [§ 20(a)] and some exchanges need prior SEC approval (§ 11). Reorganization plans must be submitted to the SEC, which can render a * * * advisory report [if requested] and seek an injunction with respect to * * * reorganizations (§ 25). * * * Accountants must meet certain criteria, be selected in a particular fashion, and perform certain functions (§ 32). The regulated companies must keep and refrain from destroying certain books and records (§§ 31 and 34). Unit investment trusts (§ 26) and face amount certificate companies (§§ 28–29) are given special regulatory treatment.

The Act curtails the pyramiding of mutual funds [§§ 12 (d)–(g)]. Unless it is itself the principal underwriter, no investment company may acquire shares of another company whose principal underwriter is related to the first company [§ 10(f)]. At least 40% of the company's board must consist of independent directors (§ 10). Advisory contracts must first be approved by a majority of [disinterested] directors * * * and by a majority of shareholders [§ 15(c)]. Investment company transactions conducted by or with affiliated persons are prohibited in some cases and narrowly circumscribed in others (§ 17).

374 F. Supp. at 99.

Section 22 of the Investment Company Act sets forth the scheme of regulation of the process of distributing and marketing mutual fund shares. Section 22(d), with certain exceptions not relevant here, requires mutual fund underwriters and all dealers to maintain the public offering price established in a mutual fund's prospectus in sales of a mutual fund's shares to all purchasers, except the fund, its underwriters, or a dealer.[6] Sections 22(a) and 22(c) empower securities associations registered with the Commission under the Maloney Act[7] and the Commission itself to regulate the minimum prices at which securities broker-dealers may buy an investment company's shares from the fund, the maximum prices at which a broker-dealer may resell those shares back to the fund, the time for computing net asset value for purposes of determining the selling price, and the time that must elapse between purchase of the securities from the fund and resale to the fund. Section 22(b) empowers a registered securities association, that is the NASD, and the Commission, to prescribe the max-

[6] The current public offering price is composed of the daily prorated "net asset value" of the fund's portfolio of investments, plus a sales commission ("load") fixed by the fund. *See Complaint*, ¶ 11 (App. 8). *See also* Section 2(a)(40) of the Act, 15 U.S.C. 80a-2(a)(40); Investment Company Act Rules 22c-1 and 22d-1; 17 C.F.R. 270.22c-1, 270.22d-1.

[7] The NASD is the only such association to register with the Commission. It was incorporated in Delaware on July 18, 1939 and became registered under the Maloney Act on August 7, 1939. *National Association of Securities Dealers, Inc.*, 5 SEC 627 (1939).

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imum sales commission or "load"[8] to be charged to public investors who purchase securities from a dealer in connection with a primary distribution of those securities.[9] Finally, Section 22(f) authorizes mutual funds to restrict the transferability and negotiability of their shares so long as such restrictions are "in conformity with the statements with respect thereto contained in" the funds' registration statements and so long as those restrictions are not "in contravention of such rules and regulations as the Commission may prescribe in the interests of the holders of all of the outstanding securities of such investment company."

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[8] *See* note 6, *supra.*

[9] As the Antitrust Division correctly points out, Brief of Appellant at 6–7, in the case of mutual funds like the defendants, the primary distribution of new shares issued by the fund occurs through sales of the fund's shares by a principal underwriter "(often an affiliate of the fund)" to dealers with whom the underwriter has sales agreements, and then to the investors. The underwriter and dealers share the sales commission or "load" paid by the investors, typically with the larger portion going to the dealer. This method of distribution is to be distinguished from the method of distributing "no load open-end funds, which do not operate through dealers but sell directly to investors at net asset value." *Ibid.*

Also the defendants should be distinguished from "'closed-end' investment companies, whose shares are not redeemable [as compared to those of open-end companies, see note 2, *supra*] and traditionally are traded in the pubic market at substantial discounts from asset value." *Ibid.*

Mutual fund shares may also be sold by means of "periodic payment plans," whereby the investor contracts to buy, in effect, a specified amount of fund shares over a period of time. Such periodic payment plans are themselves securities, and are regulated under Section 27 of the Investment Company Act, 15 U.S.C. 80a–27.

The Commission's regulatory authority under Section 22 is supplemented by its authority under Section 6(c) of the Act to grant exemptions, by way of rules, regulations or orders, from any provision of the Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of" the Act. Furthermore the Maloney Act gives the Commission extensive regulatory authority over the rules of registered securities associations. Thus, Section 15A(a) of the Act authorizes the Commission to set forth the matters which must be included in a registration statement of such an association and Section 15A (b) and (e) provide that an association shall not be registered unless the Commission is able to find that its rules meet certain standards. Section 15A(j) requires a registered association to file with the Commission amendments to its rules, and Section 15A(k) sets forth procedures whereby the Commission may alter, supplement, or amend the rules of a registered association. Furthermore, Section 15A(l)(1) authorizes the Commission to suspend or revoke the registration of a registered association. And, pursuant to Section 15A(g) and 15A(l)(2) the Commission is authorized to review any disciplinary action taken by an association against one of its members and to take action of its own to discipline a member of an association who has participated in a violation of the Securities Exchange Act, the Securities Act of

1933, or any rule or regulation adopted under those acts.[10]

The Court below found that the Commission has exercised the authority described above "actively [to regulate] * * * the pricing and distribution of mutual fund shares." [11] In particular, the Court noted that

> * * * for more than three decades, since the enactment of the 1940 Act, the agreements between dealers and principal underwriters and between principal underwriters and mutual funds [which set the terms under which fund shares are to be distributed] have been filed with the SEC. The agreements are filed under both the [Securities Act of 1933, 15 U.S.C. 77a, *et seq.*] and the 1940 Act. * * * The 1940 Act specifically calls for written contracts between funds and their principal underwriter [§ 15 (b)]. * * * [and] the Commission has approved a NASD rule which requires dealer-underwriter agreements; and Commission decisions have frequently turned on particular provisions of the dealer-underwriter agreements.[12]

B. THE ALLEGATIONS OF THE COMPLAINT

Count I of the Complaint alleges that the defendant NASD and its members, including the defendant

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[10] It should also be noted that Section 15A(n) provides:

"(n) If any provision of this section is in conflict with any provision of any law of the United States in force on June 25, 1938, the provision of this section shall prevail."

[11] 374 F. Supp. at 101. The opinion below contains an extensive recitation of the Commission's regulation of mutual fund pricing and distribution. *Id.* at 101–102.

[12] 374 F. Supp. at 101–102.

broker-dealers and principal underwriters, have combined and conspired "to prevent the growth of a secondary dealer market and a brokerage market in the purchase and sale of mutual fund shares." Complaint, ¶16 (App. 9).[13] As part of this conspiracy the complaint alleges that the NASD and its members "established and maintained rules which inhibited the development of a secondary dealer market and a brokerage market in mutual fund shares." Complaint, ¶17(a) (App. 9). The Appellant has since indicated that it

> * * * is not challenging the validity of the NASD rules themselves, [but] only the appellees' activities that have resulted in unofficial interpretations and extensions of the rules to restrict secondary markets. The rules themselves apply only to the primary distribution of mutual fund shares and do not purport to fix prices or commission rates in the secondary interdealer or broker markets.[14]

Counts II and III of the Complaint allege violations of Section 1 of the Sherman Act in connection

[13] Pursuant to the Complaint "secondary dealer market" means an inter-dealer market in mutual fund shares and a market in which any dealer can purchase mutual fund shares from investors at more than the redemption price; and "brokerage market" means the transfer, by means of a brokerage transaction, of already issued and outstanding mutual fund shares between investors, acting through broker/dealers. Complaint, ¶3(g), (h) (App. 5).

[14] Brief of appellant at 51, n. 47. Accordingly, the issue of whether an NASD rule affords antitrust immunity to persons who act in compliance with such a rule is not before this Court. *Compare Harwell* v. *Growth Programs, Inc.*, 451 F. 2d 240 (C.A. 5), opinion on rehearing, 459 F. 2d 461, cert. denied, 404 U.S. 828.

with the distribution of Fidelity Fund shares. In Count II it is alleged that Crosby Corp., in its role as principal underwriter for the Fidelity Funds, entered into dealer agreements with the defendant broker-dealers to require that:

> (a) each broker/dealer must maintain the public offering price in any brokerage transaction in which it participates involving the purchase or sale of shares of the Fidelity Funds; and
>
> (b) each broker/dealer must sell shares of the Fidelity Funds only to investors or the fund and purchase such shares only from investors or the fund.

Complaint ¶¶ 22, 23 (App. 10–11).

Count III alleges that Fidelity Fund and Crosby Corp. have entered into contracts which require that "the dealer agreements" entered into between Crosby Corp. and broker-dealers contain the "restrictive provisions" quoted above which form the basis for the violation of Count II. Complaint ¶¶ 28–30 (App. 11–12).

Count IV alleges violations of Section 1 of the Sherman Act in connection with the distribution of a group of funds with respect to which defendant Vance, Sanders acts as principal underwriter ("Vance, Sanders Funds"). Specifically Count IV alleges that Vance, Sanders and the defendant broker-dealers entered agreements which require that

> (a) in all sales of shares of Vance, Sanders Funds to the public, the broker-dealer would act as dealer for its own account; and
>
> (b) the broker-dealer would not purchase shares of Vance, Sanders Funds from other

> broker-dealers and would not sell such shares to other broker-dealers, or, in the alternative, would sell such shares to other broker-dealers only at the public offering price.

Complaint ¶ 35 (App. 13).

Count V alleges that Vance, Sanders and defendant Massachusetts Investors Growth Stock Fund have entered into and maintained contracts which require "that in all sales of shares of the Vance, Sanders Funds to the public, Vance, Sanders would act as principal for its own account." Complaint ¶ 41 (App. 14).

Counts VI and VII allege violations of Section 1 of the Sherman Act in connection with the distribution of shares of Wellington Fund, Inc. Count VI alleges that Wellington Management Company, Inc. ("Wellington"), in its role as principal underwriter of Wellington Funds, entered into contracts with the defendant broker-dealers which require that:

> (a) the broker-dealer must sell shares of the Wellington Funds only as principal, for its own account;
>
> (b) the broker-dealer must not purchase shares of the Wellington Funds from other broker-dealers and must not sell such shares to other broker-dealers; and
>
> (c) in all transaction involving Wellington and the other broker-dealers, Wellington would act only as agent for the appropriate Wellington Fund.

Complaint ¶ 47 (App. 15).

Count VII alleges that Wellington and Wellington Fund, Inc. have entered into contracts which require that:

(a) Wellington must forward all orders from investors or broker-dealers to the appropriate Wellington Fund for sale only at the public offering price; and

(b) Wellington would arrange for the purchase of shares only from the appropriate Wellington Fund.

Complaint ¶ 53 (App. 16).

Count VIII alleges that in addition to the allegations of Counts II, IV, and VI the defendant broker-dealers in violation of Section 1 of the Sherman Act have entered into and maintained contracts with other principal underwriters of mutual funds which contain one or more of the following restrictions:

(a) the broker-dealer must act as principal (dealer) only in the sale of such shares;

(b) if the broker-dealer acted as agent (broker) in the sale of such shares, it must maintain the public offering price;

(c) the broker-dealer must purchase such shares only from the principal underwriter, investors or the fund; and

(d) the broker-dealer must sell such shares only to the principal underwriter, investors, or the fund.

Complaint ¶ 58 (App. 17).

C. THE DECISION BELOW

Before discovery and trial the defendants moved to dismiss the complaint pursuant to Fed. R. Civ. P. 12(b)(6). Because it perceived the issues drawn upon those motions as strictly legal "as to which the facts as alleged in the complaint or otherwise are not rele-

vant" 374 F. Supp. at 98, the district court proceeded to an examination of the regulatory context in which the defendants' alleged conduct arose, and concluded that the complaint should be dismissed with prejudice.[15]

The district court reasoned initially that the case could "only be determined ultimately by an analysis of the several subsections of Section 22 of the 1940 Act and an antitrust exemption purportedly given by Section 15A(n) of the Securities and Exchange Act of 1934 (the Maloney Act), 15 U.S.C. 78*o*-3(n)." 374 F. Supp. 98. After reviewing the pervasive regulatory scheme over the process of mutual fund distribution, and the role of Section 22(d) in establishing resale price maintenance in the distribution of mutual funds, the district court rejected the appellant's argument

> * * * that Congress while allowing a primary market to flourish with benefit of antitrust immunity, did not intend to foreclose secondary market growth, but that such secondary markets are in fact being discouraged and suppressed by certain NASD rules and the restrictive provisions contained in the industry-wide uniform sales agreements between principal underwriters and dealers.

374 F. Supp. at 104.

Rather, the district court reasoned from the legislative history of Section 22, both as originally drafted

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[15] The district court also dismissed with prejudice the complaints filed in two private cases which alleged essentially the same courses of conduct as are alleged in the appellant's complaint. *Haddad* v. *Crosby Corp.*, No. 2454–72 (D.D.C.); *Gross* v. *NASD*, No. 426–73 (D.D.C.).

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and as reviewed by subsequent Congresses in recent years, "that Congress designed § 22(d) and 22(f) to create and protect a primary distribution system which is repugnant to the antitrust laws and did so in complete recognition of the fact that the legislation would frustrate the growth of a free secondary market." 374 F. Supp. at 109. Thus, the court found that Section 22(d) was intended, through the mechanism of resale price maintenance imposed on contract and non-contract dealers in sales to investors, to eliminate certain abuses resulting from "the cut-price competition" that the court found to have existed between the primary distribution market and the secondary market in mutual fund shares prior to 1940. 374 F. Supp. at 105–106. These abuses included discrimination in the prices charged similarly situated investors and disruption of the primary distribution system. *Id.*

Similarly, the district court found that as another method of overcoming the "disruptive influence upon the market in mutual fund shares by the practices of non-contract dealers and brokers" Congress through Section 22(f) provided

> * * * that if (1) restrictions on transferability or negotiability are included in the registration statement, and if (2) these restrictions are not in contravention of such rules and regulations as the commission may prescribe in the interests of the shareholders, then such restrictions are permissible even if they create departures from antitrust standards.

374 F. Supp. at 108. Thus, the district court found that "Congress sanctioned such restrictions with full knowledge of their effect upon a secondary market

which existed at the time and in full recognition of the antitrust implications." 374 F. Supp. at 109. Further, the court noted that "restrictions on alienability have consistently appeared in registration statements and uniform sales agreements" filed with the Commission since passage of the Investment Company Act and the Commission, while noting the existence of these provisions, has never made any attempt to prohibit them. *Ibid.*

When this regulatory scheme was scrutinized in light of this Court's prior pronouncements concerning the resolution of other regulatory schemes and the "fundamental economic policy" represented by the antitrust laws, the district court found that the conduct challenged by the appellant was entitled to a "limited antitrust exemption." 374 F. Supp. at 114. The Court concluded that

> * * * Congress clearly intended to substitute a pervasive regulatory scheme, *i.e.,* § 22 of the 1940 Act, for the usual antitrust prohibitions in the narrow area of distribution and sale of mutual fund shares, it is [therefore] clear that the price maintenance practices complained of are immune from ordinary antitrust strictures.

Ibid.

THE INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Investment Company Act of 1940 vests in the Commission pervasive authority to regulate the process of distributing mutual fund shares and the role of retail price maintenance in that process. As will be seen, this grant of jurisdiction reflects Congress' determination that the complex process of balancing

conflicting public policy considerations required in regulating mutual fund distribution made that area appropriate for administrative oversight rather than direct, rigid legislation.

Over the last decade, however, the continued appropriateness of retail price maintenance in the process of mutual fund distribution has come under increasing question by the Commission and by Congress. Thus, in 1969 the Senate Committee on Banking and Currency of the Ninety-First Congress considered legislation to repeal Section 22(d), but after receiving "impressive testimony * * * that there had not been sufficient study of the consequences of such an amendment" that committee requested the Commission "to review the consequences of such a proposal on both the investing public and mutual fund sales organizations."[16]

In response to this mandate and after extensive study the Commission published SEC, *Report of the Staff on the Potential Economic Impact of a Repeal of Section 22(d) of the Investment Company Act of 1940* (November, 1972) ("Staff Study"). The Staff Study and the Commission deliberately refrained, however, from

> * * * making any definitive recommendations to the Congress as to what should or should not be done about Section 22(d), [rather the Commission will] hold public hearings at which interested persons will be asked to direct [the Commission's] attention to aspects of the mu-

[16] S. Rep. No. 184, 91st Cong., 1st Sess. 8.

> tual fund sales compensation problem that the report may have overlooked or to which it may have given insufficient weight.[17]

Subsequently, after holding hearings on a broad range of subjects related to the distribution of mutual fund shares,[18] the Commission forwarded to Congress a report prepared by its Division of Investment Management Regulation entitled *Mutual Fund Distribution and Section 22(d) of the Investment Company Act of 1940* (August, 1974) ("Staff Report"). The Staff Report sets forth a wide-ranging administrative and legislative program for the reduction or elimination of "many of the inequities and inefficiencies of the present fund distribution system" as well as "the gradual and orderly introduction of retail price com-

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[17] Letter of transmittal of Staff Study from SEC Chairman William J. Casey to the Honorable John Sparkman, Chairman of the Senate Committee on Banking, Housing and Urban Affairs (November, 1972) at vi.

[18] *See* Investment Company Act Release No. 7475 (November, 1972) which outlined the issues to be considered in the hearings as follows:

A. Repeal of Section 22(d) of the Act.
   1. Complete repeal.
   2. Partial repeal.
   3. Price competition within a limited range.
   4. A current public offering price described in the prospectus.
   5. Prohibit price competition from non-contract dealers.

B. Rules under Section 22(b) and other provisions of the Act.
   1. Lower breakpoints reflecting the reduced cost of diversification on larger purchases.
   2. Regulation of the dealer-discount.
   3. Continuous discounts.

petition into the mutual fund distribution system."[19]

The Commission's approach to effectuation of this program was influenced by its realization that

> * * * Implicit in the decision of Congress to establish a thoroughgoing statutory scheme to govern mutual funds is * * * a determination that mutual funds are a product which, with appropriate safeguards, should be made available to the public.[20]

Accordingly, the Commission was not "prepared to take or recommend action which might result in an abrupt end to fund distribution."[21] Therefore, the Commission's program took "a middle path intended to reduce or eliminate many of the inequities and inefficiencies of the present fund distribution system while, at the same time, avoiding the dangers of a sudden abolition of retail price maintenance."[22]

As part of this program which has been developed over five years, the Commission announced that it

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4. The value of additional product features.
5. Contractual plans.

C. Further liberalization of advertising rules.
1. Advertising.
2. Statement of Policy.

D. Simplified more readable mutual fund prospectuses.
E. Group sales.
F. Reducing paperwork in small transactions.
G. No-load sales.
H. Development of an adequate economic data base.

In addition, persons participating in the proceeding were invited to address relevant issues other than those enumerated. The hearings were held in February and March, 1973. Some seventy persons appeared and more than 100 written comments were filed. Chairman Garrett letter, *supra*, n. 5 at iii.

[19] Chairman Garrett letter, *supra*, n. 5 at v.

[20] *Ibid.*

[21] *Ibid.*

[22] *Ibid.*

intends to take action with respect to the very conduct at issue in this lawsuit, that is, contractual agreements between mutual funds, their underwriters and contract dealers which may have the effect of restricting secondary market transactions in mutual fund shares. Thus, with respect to *brokerage* transactions the staff report made a recommendation (which the Commission adopted) that the NASD be requested to amend its rules to prohibit, with certain appropriate qualifications, contractual provisions in the sales agreements between principal underwriters and contract dealers, which require either that a broker-dealer refrain from acting as agent in a sale of already issued shares between two investors or, if it does act as agent that it nevertheless maintain the public offering price.[23] This action, the report explained, would, in the context of the gradual introduction of retail price competition, help "to develop price sensitivity among investors" and would provide "important insight into whether a secondary *dealer* market could function effectively."[24] The Staff Report further noted that if the NASD refused to adopt such a rule, or if funds attempted to bypass the rule by directly restricting the transferability of shares in brokered transactions, then the Commission could take direct regulatory action under Section 22(f).[25]

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[23] Staff Report at 104–109. The Commission has since sent a letter to the NASD requesting this action. *See* p. 56, *infra*.

[24] *Id.* at 105.

[25] *Id.* at 105. The report also noted that the Commission could prohibit these restrictions under Section 15(c)(2) of the Securities Exchange Act, 15 U.S.C. 78*o*(c)(2), which provides:

"(2) No broker or dealer shall make use of the mails or

The Staff Report also recommended that the Commission ask Congress to clarify the Commission's authority to effect an administrative abolition of the retail price maintenance requirements of Section 22 (d) when such action becomes appropriate during the course of the Commission's program.[26] In this connection, the Staff Report expressed concern as to whether or not a secondary market in fund shares maintained by noncontract dealers would have an adverse effect on the primary distribution process during the period of adjustment to retail price competition. Further, the staff noted that underwriters would be unable to charge secondary market dealers for their fair share of costs incurred in the distribution, such as advertising, which would benefit all dealers. This fact could, in the view of the Staff Report, result in unfair competitive advantages to the secondary market dealers, again disrupting the distribution process.[27] Accordingly, the Staff Report suggested the possibility of prohibiting the development of a sec-

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of any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation. The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious."

[26] Staff Report at 115–121.

[27] *Id.* at 119, 120.

ondary non-contract dealer market in fund shares for some period during the introduction of price competition, and further suggested allowing funds and underwriters to impose fair costs on the secondary market dealers in order to eliminate disruptive competitive advantages which may accrue to those dealers.[28]

As will be seen, the contractual provisions challenged under the antitrust laws in this lawsuit are precisely the kind of restrictions on transferability and negotiability of mutual fund shares which Congress authorized in Section 22(f), absent limiting Commission rules. The Commission's determination at the present time not to exercise its authority under Section 22(f) to totally eliminate those restrictions can only be taken to mean that in the context of its present regulatory program involving mutual fund distribution, it does not view that action as appropriate. Yet, the appellant, in this lawsuit, seeks to reverse that regulatory judgment of the Commission by asserting that the defendants' conduct, in contractually restricting the development of secondary broker and inter-dealer markets of fund shares, violated the antitrust laws and can be enjoined under the antitrust laws.

[28] This secondary market in mutual fund shares maintained by non-contract dealers, about which the Commission has expressed reservations, is, of course, the "inter-dealer market" which the Antitrust Division seeks to establish through this lawsuit. Accordingly, the appellant was incorrect in asserting that the Commission Staff Report "did not discuss the inter-dealer market." Brief of Appellant at 39, n. 34.

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Granting the injunctive relief sought by the appellant would therefore reverse Congress' legislative judgment, recognized by the court below, that the elimination or modification of the mutual fund marketing structure "mandated by Congress in 1940" "is an issue for Congress and the SEC, not the Judicial Branch, to hear and to decide." 374 F. Supp. at 109. Similarly, granting the plaintiff's requested injunctive relief would impede the very exercise of Commission regulatory authority that Congress contemplated and provided for in 1940.

SUMMARY OF ARGUMENT

The basic question on this appeal is whether the defendants may, free from the antitrust laws, contractually restrict the terms under which the defendant underwriters and dealers trade in shares of the defendant funds. These contractual restrictions were entered into in the context of the primary distribution of mutual fund shares, which, as discussed above, is regulated by the Securities and Exchange Commission under the Investment Company Act and the Maloney Act.

While "[r]epeal of the antitrust laws is not to be lightly assumed"[29] they are nevertheless impliedly repealed to enable a federal regulatory scheme to work.[30] In the present case a searching inquiry into the gen-

[29] *Ricci* v. *Chicago Mercantile Exchange*, 409 U.S. 289, 303.

[30] *See Silver* v. *New York Stock Exchange, Inc.*, 373 U.S. 321, 357.

esis and aims of the regulatory scheme [31] reveals that Congress intended, through Section 22 of the Investment Company Act, to give the Commission power to regulate the distribution of mutual fund shares and the secondary market of those shares. In particular Congress intended, through Section 22(f), to curb certain abuses occurring in the secondary market of fund shares by authorizing mutual funds and their underwriters to control and restrict secondary markets in their shares, subject to Commission regulation. This regulatory scheme will not work if activity authorized under Section 22(f), which the Commission does not prohibit, can be challenged under the antitrust laws.

ARGUMENT

THE CONTRACTUAL PROVISIONS WHICH FORM THE BASIS OF THIS LAWSUIT ARE SUBJECT TO REGULATION BY THE SECURITIES AND EXCHANGE COMMISSION UNDER THE FEDERAL SECURITIES LAWS, AND IN PARTICULAR UNDER SECTION 22(f) OF THE INVESTMENT COMPANY ACT, AND ARE IMMUNE FROM ANTITRUST ATTACK

A. THE ORIGINS OF SECTION 22

Because it noted a similarity between problems related to the control and management of investment companies and problems involving the control and

[31] *See, e.g., Federal Maritime Commission* v. *Seatrain Lines, Inc.*, 411 U.S. 726, 732, 736–739; *Otter Tail Power Co.* v. *United States*, 410 U.S. 366, 373–74; *United States* v. *Philadelphia National Bank*, 374 U.S. 321, 350–352; *United States* v. *R.C.A.*, 358 U.S. 334, 339–376. *See also Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Ware*, 414 U.S. 117.

management of public utility holding companies, Congress, in 1935, through Section 30 of the Public Utility Holding Company Act, 15 U.S.C. 79z-4, directed the Commission to make a study of investment trusts and investment companies and to direct its findings to Congress.[32] In response to that mandate, the Commission prepared its *Report on Investment Trusts and Investment Companies,* Parts One through Five (1939-1941) (Investment Trust Study).

The Investment Trust Study focused particular attention on problems and practices related to the distribution of shares of open-end investment companies (or mutual funds) like the defendants in this case.[33] Underlying the structure of mutual fund distribution, as well as "other factors, such as capital structures, investment policies and management discre*tion*",[34] the study noted, were two essential features:

> (1) The continuous offering of securities at prices which will net the fund amounts equivalent to the net asset value of each outstanding share at the time of sale; and
>
> (2) The obligation of the investment company to redeem or repurchase its outstanding shares by paying the equivalent of the net asset value per share (in some cases less a small redemption fee.) [35]

These features had the practical effect of stabilizing the price of mutual fund shares since an investor

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[32] S. Rep. No. 621, 74th Cong., 1st Sess., p. 10.

[33] *See generally*, Investment Trust Study, Part II, at 211-222, 241-244; Part III, at 799-874.

[34] Investment Trust Study, Part III at 799.

[35] *Id.*, Part III at 799; Part II at 213-214.

would always receive asset value for his shares upon redemption.[36] On the other hand, the obligation to redeem also posed a threat that redemptions may be greater then sales, thus resulting in dimunition of the fund's assets with the possibility of forcing liquidation of the fund.[37] This threat of "substantial redemptions" influenced furd management to concentrate their investments in well known shares which could be readily liquidated to meet redemption demands.[38] It also caused the funds continuously to market their shares and to place great emphasis on the success of their sales programs.[39]

At the top of the distribution mechanism was the principal distributor or underwriter who contracted with the company "to buy its shares or act as agent in their sale at a price which will net the company an amount equal to their asset value."[40] The underwriter was usually affiliated with the sponsor of the fund, and the organization hired by the fund to manage its portfolio.[41]

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[36] *Id.*, Part III at 806; Part II at 241.

[37] *Id.*, Part III at 806–809.

[38] *Id.* at 806, 820–823.

[39] *Id.*, Part III at 801, 807–808, 856. The importance placed on a continuous marketing program in 1940 can be seen from the observation of the Investment Trust Study "that for each dollar invested in open-end investment companies as of the end of 1936 it was necessary to market almost three dollars worth of shares." *Id.* at 809.

[40] *Id.*, Part II at 214–215; Part III at 823.

[41] *Id.*, Part II at 215; Part III at 804, 823; *see also* Hearings Before a Subcommittee of the Senate Committee on Banking and Currency on S. 3580, 76th Cong., 3d Sess., at 152 (Senate Hearings).

From the underwriter, fund shares were then distributed to investors through a network of dealers organized for the fund by a group of middlemen or wholesalers.[42] The price to the investor was, at least in theory, composed of a sum related to the net asset value of the fund's shares plus a sales load intended to compensate the members of the selling chain.[43] When a fund was threatened by increased redemptions there usually resulted "increased selling pressure [by providing salesmen] with higher loading charges to overcome the diminution in the size of the company caused by the redemptions."[44] Similarly, competition among funds to obtain and retain dealers had the effect of preventing "the reduction of loading charges."[45]

Because mutual fund shares could always be redeemed at net asset value, there was apparently no incentive to develop a secondary exchange market in fund shares.[46] However, the Investment Trust Study

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[42] Investment Trust Study, Part II at 215.

[43] *Ibid.*

[44] *Id.*, Part III at 856.

[45] *Id.*, Part III at 826. A study of the mutual fund industry forwarded to Congress by the Commission in 1966 revealed that the same distribution process was operating at that time, including the same relationship between selling pressure and the size of sales loads. Securities and Exchange Commission, *Report on the Public Policy of Implications of Investment Company Growth*, H. Rep. No. 2337, 89th Cong., 2d Sess. at 54.

[46] Investment Trust Study, Part III at 805, 855. Furthermore, the fact that open-end companies were continuously issuing and redeeming shares on the basis of net asset value made the price of open-end shares relatively impervious to the forces of supply and demand, except insofar as a high rate of redemption might tend to cause higher sales loads. *Id.* at 855.

revealed that secondary over-the-counter markets in mutual fund shares did exist.[47] These markets were maintained in part by dealers and underwriters who were part of the distribution chain of a particular fund.[48] The secondary market of these persons involved purchasing shares from investors for the underwriter's or dealer's own account (instead of turning them into the fund for redemption), and then immediately reselling those shares to other investors.[49] In the case of a dealer, this type of transaction resulted in increased profits because the distributor, not having furnished the shares, received no portion of the sales load.[50] These persons also maintained inventories in a fund's shares (the shares being purchased either from investors or from the fund) and would service their customers' orders out of their inventory when the price paid for the inventory shares was less than the public offering price—thus potentially retaining both the sales load and any increase in net asset value between the time the inventory share was purchased and the time it was resold to an investor.[51] Furthermore, in the case of a dealer, all element of

[47] The Investment Trust Study suggests that the secondary over-the-counter market in mutual fund shares which was operating in 1940 was a dealer market, rather than a brokerage market in which investors sold their shares through an agent. *Id.*, Part II at 327.

[48] *Id.*, Part III at 856–857.

[49] *Id.*, Part II at 242; Part III at 805, 809, 856–863.

[50] *Id.*, Part II at 242; *cf. Id.*, Part III at 859.

[51] *Id.*, Part III at 859.

risk was removed by the operation of the "two-price" system (see p. 33–35, *infra*).

Another kind of secondary market activity was engaged in "by dealers who traded in the shares of open-end investment companies without the authority of the principal distributors for those companies."[52]

In the cases of both types of secondary market activity described above the bid price was normally slightly higher than the redemption price of the fund and the asked price was slightly less than the price in the primary distribution of the fund.[53] With respect to the activity of unauthorized dealers the Investment Trust Study noted:

> * * * In an active market the unauthorized dealer could still get a greater spread than the authorized dealer. A certain amount of protection was received by such operators through their ability to obtain shares from the legitimate distributors if these dealers were short. Such operations actually had the effect of initiating a small scale price war between retailers and tended generally to disrupt the established offering price.[54]

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[52] *Id.* at 865.

[53] *Id.* at 857, 865. Because the secondary market bid price was a little more than the redemption price, retiring investors were induced to sell their shares in the secondary market rather than redeeming their shares with the fund. Another factor enabling secondary market dealers to induce shareholders to sell their shares instead of redeeming was that the dealer could offer the outgoing shareholder immediate cash payments, whereas if the shares were redeemed, their exact value might not be computed until the next day. *Id.* at 857.

[54] *Id.*, Part III at 865 (footnotes omitted).

The Investment Trust Study also noted, with respect to secondary dealer market activity generally, "that there was considerable activity by dealers in switching customers from one open-end investment company to another." [55]

In addition to the secondary markets which operated at the retail level, the Investment Trust Study also noted the existence of certain "trading firms" which apparently competed with the underwriters and wholesalers by selling to dealers at a discount from the price available from the underwriters and wholesalers.[56] The Investment Trust Study used the term "bootleg market" with respect to, variously, (1) the market made by trading firms; [57] (2) the secondary market made by unauthorized dealers; [58] and (3) the market which "bids higher and offers at lower prices than the principal distributor." [59]

The Investment Trust Study noted that the existence of secondary dealer market activity in mutual fund shares was related to another aspect of the

[55] *Id.* at 809; *see also Id.*, Part II at 221. Switching activity was detrimental to the investor because he had to pay a new load each time he purchased new shares. *Id.*

[56] Investment Trust Study, Part II at 325–328. The study indicates that the trading firms "bought chiefly from other dealers, presumably both other wholesale firms and retail dealers." *Id.* at 327.

[57] *Id.*, Part II at 328, n. 85.

[58] *Id.*, Part III at 865. *See also*, Heffernan & Jorden, *Section 22(d) of the Investment Company Act of 1940—Its Original Purpose and Present Function*, 1973 Duke Law Journal, 975, 978 ("Heffernan & Jorden").

[59] Investment Trust Study, Part II at 241, n. 100.

mutual fund distribution process operating in 1940—the series of abuses and practices related to the "two-price" system. The "two-price" system resulted from what was then a commonly used method of computing the net asset value of a fund's shares.[60] By this method the net asset value of a fund's shares was computed on the basis of the fund's portfolio value at the close of the trading markets on the previous day. But, even though the markets closed some time in the afternoon, the new price did not go into effect until the next morning. Accordingly, between close of the market on one day, and the time when the price became effective on the next day, there were two operative prices for the fund's shares, the price in effect during the trading day and the price that would go into effect for the next day.[61]

Because the differential between the two prices was very rarely greater than the load, public investors were generally not able to take advantage of this two-price system.[62] But, dealers were allowed by funds to purchase shares for their own accounts from the principal distributor and other dealers at a discount from the public load. This ability to purchase at discount enabled a fund's dealers, and to some extent its principal distributor, to take advantage of their foreknowledge of the next day's prices for the fund's

[60] *Id.*, Part III at 851; Senate Hearings at 187.

[61] *See generally*, Investment Trust Study, Part III at 850–855; Senate Hearings at 135–159, 835–863; Heffernan & Jorden at 979–981.

[62] Investment Trust Study, Part III at 862.

shares in order to engage in "riskless trading" in the fund's shares.[63]

Certain insiders of funds also had the advantage of being able to purchase shares at a discount from the published load and therefore could engage in riskless trading.[64] Riskless trading had the effect of diluting existing shareholders' equity since the person who purchased shares under such circumstances became immediately entitled to redeem his shares on the next day for more than he had paid into the fund.[65]

The Investment Trust Study lists a variety of means used by funds to combat the various problems discussed above related to the distribution process. With respect to the secondary markets maintained by unauthorized dealers "certain open-end companies * * * [restricted] the negotiability of their shares, providing substantially that the shares could only be sold or tendered for redemption to the open-end investment company."[66] Thus, one company stated in its prospectus that its shares were "non-transferable, in the absence of the consent of the corporation, unless the registered holder * * * has first offered same

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[63] *See generally*, Investment Trust Study, Part II at 218–220, Part III at 856–865; Heffernan and Jorden at 979–984.

[64] Investment Trust Study, Part III at 871, Senate Hearings at 289, 660–61, 1057, Hearings Before a Subcommittee of the House Committee on Interstate and Foreign Commerce on H.R. 10065, 76th Cong., 3d Sess. at 58–59 (House Hearings); H. Rep. No. 2639, 76th Cong., 3d Sess. at 8 (House Report); S. Rep. No. 1775, 76th Cong., 3d Sess. at 7 (Senate Report).

[65] Investment Trust Study, Part III at 865–867; Senate Hearings at 138–139.

[66] Investment Trust Study, Part III at 861.

to the corporation and it has failed to purchase the shares." [67]

Certain open-end companies also attempted to limit the abusive trading practices related to distributors' and contract dealers' over-the-counter market trading, and riskless trading, under the two-price system by imposing limitations on the right to purchase and sell their shares.[68] These limitations often involved prohibiting the underwriter from taking any trading position in the fund's shares and requiring the underwriter to fill only bona fide orders received by dealers from their customers.[69] Another device used by one company was to distribute directly through dealers rather than an underwriter. "The selling contracts [used by this company] did not permit dealers to make resales of shares to persons other than bona fide investors without the consent of the investment company nor at any prices other than the established sales premiums." [70]

Following its Investment Trust Study the Commission submitted its recommendations for legislation in identical bills to the Senate and House, S. 3580 and

[67] *Id.* at 865, n. 342.

[68] *Id.*, Part III at 867–874.

[69] *Id.* at 867–869.

[70] *Id.* at 871. The Investment Trust Study also describes the direct elimination of the "two price" system by certain companies through the means of computing the sales and redemption prices based on the value of the fund's portfolio at close of the day the order is received. *Id.* at 870–874. This method of "foreward pricing" a fund's shares for redemption and sales purposes was eventually mandated for the industry by Investment Company Act, Rule 22c-1, 17 C.F.R. 270.22c-1.

H.R. 9835.[71] As explained by Senator Wagner in introducing S. 3580, that bill was intended to go beyond the "full and fair disclosure" regulation of previous federal securities laws and to "eliminate and prevent those deficiencies and abuses in [investment companies] * * * which have contributed to the tremendous losses sustained by their security holders."[72] S. 3580 was designed

> * * * to eliminate wherever possible * * * [abuses and deficiencies in the organization, sales of the securities and operation of investment companies] by direct prohibition of their continuance. Only in the comparatively few cases where the problems are complex and technical is a regulatory power vested in the Commission to correct malpractices by rules, regulations or orders promulgated in accordance with precise standards prescribed in the bill.[73]

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[71] 76th Cong., 3d Sess. *See generally*, Heffernan & Jorden at 984.

[72] Cong. Rec. Daily, March 14, 1940, at 4412. In introducing S. 3580 Senator Wagner noted that with regulation, investment companies could become an important financial institution in the national economy. *Id.* at 4413.

[73] *Id.* at 4413; *see also*, Senate Hearings at 45. One important regulatory authority granted the Commission in S. 3580 and H.R. 9835 was Section 6(c). That section, which survived subsequent redrafting of the bill as a whole to be retained in the same position and virtually the same form in the Investment Company Act (see p. 11, *supra*), provided:

"* * * The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security or transactions from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that the Commis-

Section 22 of the proposed legislation authorized the Commission "to adopt rules and regulations to protect investors against dilution of their equity caused by pricing abuses in the distribution and redemption" of investment securities and to prohibit "grossly excessive" sales loads on mutual fund securities.[74] Section 22 of S. 3580 and H.R. 9835 provided in relevant part:

> SEC. 22 (a) No registered investment company or principal underwriter therefor shall sell, redeem, or repurchase any redeemable security of which such a company is the issuer, except at a price bearing such relation to the current asset value of such security, computed as of such time, as the Commission shall prescribe by rules and regulations or orders, for the purpose of eliminating or reducing to a practical minimum any dilution of or accretion to the current asset value of any other securities of such company as a consequence of such sale, redemption, or purchase.
>
> (b) No underwriter or dealer in connection with a primary distribution of redeemable securities of which any registered investment company is the issuer, shall purchase any such security from the issuer or from any underwriter except at the price at which he sells such

sion finds such exemption necessary or appropriate in the public interest and consistent with the protection of investors." This "broad exemptive power" was intended to allow the Commission to correct the harmful effect of any complete prohibition of conduct contained in the statute which "does not work out." Senate Hearings at 293.

[74] Cong. Rec. Daily, March 14, 1940, at 4414. *See also* Senate Hearings at 288.

security, less a commission or spread allowed him by the person selling to him.

* * * * *

(d) The Commission is authorized by rules and regulations or order in the public interest or for the protection of investors, to prohibit—

* * * * *

* * * (2) restrictions upon the transferability or negotiability of any redeemable security of which any registered investvestment company is the issuer." [75]

David Schenker, Chief Counsel for the Investment Trust Study, explained in the Senate Hearings on S. 3580 [76] that Section 22(a) of that Bill was intended to give the Commission "power to formulate rules and regulations" to deal with "the possible dilution of the equity of certificate holders in open-end companies." [77] Section 22(b) was intended to eliminate "riskless-trading" by "dealer[s] or 'insiders' or people who are 'in the know' " and who were in a position to purchase securities under the two price system.[78]

Finally, Section 22(d)(2), Mr. Schenker explained, authorized the Commission to make "rules and regu-

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[75] Section 22(c) authorized the Commission to prohibit the sale of investment company securities at grossly excessive loads. Section 22(d)(1) authorized the Commission to adopt rules to prohibit the suspension of the redemption privilege of an investment company's securities.

[76] The House did not hold hearings on S. 3580's companion bill, H.R. 9835, 76th Cong., 3d Sess.

[77] Senate Hearings at 288; Mr. Schenker noted that the investment company industry expressed some concern over Section 22(a) because they thought "it may have some undesirable consequences in connection with their distribution activities." *Ibid.*

[78] *Id.* at 289.

lations with respect to any restrictions upon the transferability and negotiability of any redeemable security of which any registered investment company is the issuer."[79] This provision, he went on, was intended to deal with the "technical problem" of the "bootleg market" in which

> * * * dealers keep switching people from one company to another. In order to prevent these switches, some provisions require that you cannot make these switches but must sell the certificate back to the company.[80]

By way of example Mr. Schenker referred to "some companies that have a provision in their certificates to the effect that you cannot sell that certificate to anybody else, and the only way you can sell it is to sell it back to the company."[81] Mr. Schenker stated that while he recognized that the bootleg market was a "big problem," it seemed to him that such restrictions "are taking away a big portion of the owner's right of initiative."[82] Mr. Schenker further recommended that rather than mandating an explicit provision in the statute, the subject "ought to be a matter of rules and regulations."[83]

In other testimony on S. 3580 representatives of the Commission and the mutual fund industry debated extensively on how best to regulate the problems of dilution and riskless trading by insiders caused by the

[79] *Id.* at 292.
[80] *Ibid.*
[81] *Ibid.*
[82] *Ibid.*
[83] *Id.* at 293.

two-price system.[84] The industry, while agreeing that regulation was necessary, argued that the problem of dilution caused by the activities of dealers and underwriters should be regulated by the industry itself through the mechanism of the Maloney Act.[85] The industry also argued that riskless trading by insiders should be prohibited through a prohibition on the sale of securities by an investment company "to insiders or to anyone other than an underwriter or dealer except on the same terms as are offered to other investors."[86]

The regulation of restrictions on transferability and negotiability contained in Section 22(d)(2) of S. 3580 generated little comment in the Senate Hearings other than the testimony of one member of the industry that such restrictions imposed by funds he was affiliated with were intended "for the protection of the shareholders, as well as of the management" of the funds.[87]

Subsequent to the Senate Hearings on S. 3580 representatives of the Commission and of the industry conferred over their various differences with respect to that bill and eventually produced a memorandum of agreement on legislation that both sides could sup-

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[84] *See* Senate Hearings at 135–153, 288–289, 514–528, 548–556, 612, 660–661, 672–674, 836–863, 940–941, 1057, 1085–1095. *See also*, Heffernan and Jorden at 984–994.

[85] Senate Hearings at 525, 660, 1057.

[86] *Id.* at 1057. This suggestion appears to have been modeled on a regulation of the Division of Securities of the State of Ohio. *Id.* at 526–527, 548–554. *See also*, Heffernan & Jorden at 988–993.

[87] Senate Hearings at 708–709.

port.[88] Later a bill reflecting this memorandum was prepared, which, with amendments by the House not relevant to this case, became the Investment Company Act of 1940.[89]

The memorandum of agreement provided that the "subject matter of subsections (a), (b) and (c) of Section 22 [of S. 3580] * * * relative to pricing, dilution and load" would be dealt with in the following manner:

> (a) an express provision authorizing an association under the Maloney Act (for example, N.A.S.G. [sic]) to make rules covering this subject matter.
>
> (b) a grant of equivalent power to the Securities and Exchange Commission, provided that the same shall not be exercised for one year from the effective date of the act.
>
> * * * * *
>
> No security issued by an investment company shall be sold to insiders or to anyone other than an underwriter or dealer, except on the same terms as are offered to other investors. * * *[90]

The memorandum of agreement also provided that "restrictions on transferability of shares shall be subject to rules and regulations of the Commission."[91] These provisions of the memorandum of agreement are reflected in Sections 22 (a), (b), (c), (d), and (f) of the Investment Company Act.

[88] *Id.* at 1105–1109; Hearings on H.R. 10065 Before the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. at 71–72, 96.

[89] S. 4108 and H.R. 10065, 76th Cong., 3d Sess.

[90] House Hearings at 99.

[91] *Ibid.*

The legislative history thus reveals that Section 22 of the Investment Company Act was intended to provide Securities and Exchange Commission regulation over the abuses and practices which the Investment Trust Study noted in connection with the distribution of, and secondary market trading in, mutual fund shares. Subsections (a) and (c) were intended to deal directly with the dilution problem as it related to trading by dealers in the underwriting chain. Subsection (b) dealt with the problem of excessive loads charged by persons in the primary distribution process.

The similarity between subsection (d) and the recommendations by representatives of the investment company industry as to the appropriate method for curbing riskless trading by insiders, suggests that the elimination of discriminatory prices to insiders was at least one purpose of that subsection.[92] This same result could have been accomplished by some other method,[93] however. In view of this fact, and in view of the fact that Section 22(d) requires both contract dealers and secondary market dealers to sell only at the public offering price stated in the fund's pro-

[92] *Accord* Heffernan & Jorden at 978.

[93] *See* Heffernan and Jorden at 993 where the authors note that Congress considered eliminating riskless trading by insiders through the imposition of a holding period like that contained in Section 16(b) of the Securities Exchange Act, 15 U.S.C. 78p(b), and through the prohibition of the two-price system, but that neither of these measures was incorporated in the Investment Company Act. The two-price system in the sale of mutual fund shares is now in effect prohibited by Investment Company Act Rule 22c-1, 17 CFR 270.22c-1, adopted in 1968. *See also* Brief of Appellant at 29–30.

spectus, it is probable that Section 22(d) also manifests a Congressional intent to protect contract dealers from the price competition of a secondary dealer market.[94] This purpose of Section 22(d) is further suggested by the fact that prior to the passage of S. 4108, secondary market dealers in mutual fund shares apparently alerted the Commission and the Senate to the consequences of Section 22(d) to their business in an unsuccessful attempt to have that section amended.[95]

Subsection (f) of Section 22, however, was clearly intended to allow funds to restrict over-the-counter transactions in their shares subject to Commission regulation. This is evident from the testimony of Mr. Schenker (*see* pp. 39–40, *supra*) that Section 22(f)'s predecessor was related to the problem of the bootleg market as well as the similarity between Section 22 (f)'s use of the term "restrictions on transferability and negotiability" and the devices which, as discussed above, the Investment Trust Study alluded to with respect to mutual fund attempts to control the second-

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[94] *Accord*, Heffernan and Jorden at 993.

[95] *See* Exhibits A and B, Reply Memorandum in Support of Motions by the Defendant Dealers to Dismiss the Complaints, *United States* v. *National Association of Securities Dealers*, No. 338–73 (D.D.C.) filed July 20, 1973 (App. 309–322). Thus, a memorandum on Section 22(d) of S. 4108, which was submitted to the Commission prior to the passage of S. 4108 by a firm which engaged in secondary market transactions in fund shares without participating in the primary distribution system, after analyzing Section 22(d), concludes that that section was designed to "effectively hamper [non-contract] * * * dealers in dealing in trust shares, concentrate such transactions in the hands of authorized dealers and principal underwriters, and thus create a virtual monopoly." *See* Exhibit A, *supra* (App. 315).

ary market activities of dealers in their shares. Indeed, the appellant concedes in its brief that Section 22(f) was intended to deal with the issues created by the bootleg market.[96]

B. THIS LAWSUIT MUST BE VIEWED IN THE CONTEXT OF THE RETAIL PRICE MAINTENANCE SCHEME ESTABLISHED IN SECTION 22(d) OF THE INVESTMENT COMPANY ACT

The District Court held that "the creation and maintenance of a free and open secondary market would be totally inconsistent with and might destroy the primary marketing system that is created by the 1940 Act, and particularly by § 22(d)."[97] Insofar as this holding suggests that a secondary *brokerage* market is inconsistent with Section 22(d), the Commission does not concur. The Commission has repeatedly taken the position that Section 22(d) does not prohibit brokered transactions in fund shares at other than the public offering price.[98] Further, as noted above (see p. 23, *supra*), the Commission has recently followed the recommendation of its Staff Report that under present conditions in the mutual fund industry it is appropriate for it to take steps to bring about a secondary brokerage market in mutual fund shares so long as certain safeguards are also adopted.[99]

But the Commission's determination to introduce a measure of price competition into the process of mar-

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[96] Brief of Appellant at 32, n. 27.

[97] 374 F. Supp. at 104.

[98] Opinion of the General Counsel, Investment Company Act Release No. 78 (March 14, 1941) 11 Fed. Reg. 10992; *Oxford Co., Inc.*, 21 S.E.C. 681, 690 (1946); letter from Chief Counsel, Division of Investment Management Regulation to George A. Bailey, Jr. (April 24, 1973) (App. 247); Staff Report at 104.

[99] Staff Report at 104–109.

keting mutual fund shares through the development of a secondary brokerage market should not be taken to indicate that the retail price maintenance policy of Section 22(d) should no longer be given any effect. As noted above, Section 22(d), *inter alia,* manifests an intention to protect the primary distribution process of mutual fund shares from any disruptive effect caused by price competition from a secondary *dealer* market. Furthermore, it is undisputed that Section 22(d) has had the effect of eliminating the only significant source of price competition to the primary distribution process of mutual fund shares which existed prior to 1940—the secondary dealer market. The development of the mutual fund industry under 30 years of retail price maintenance, and Congress' refusal to repeal that section without greater study, require that any modification of retail price maintenance in the mutual fund industry be accomplished by the Commission through a carefully considered regulatory program, so as not to cripple the mutual fund industry.[1]

Accordingly, it is necessary to view the conduct at issue in this lawsuit in the context of the retail price maintenance scheme established by Section 22(d). This perspective reinforces the Commission's basic

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[1] The Commission itself is granted broad authority under Sections 6(c) and 38(a) of the Investment Company Act, 15 U.S.C. 80a-6(c), 80a-38(a) as well as under the Maloney Act to regulate the scheme of retail price maintenance which is mandated for the mutual fund industry by Section 22(d). *See Baum* v. *Investors Diversified Services, Inc.*, 286 F. Supp. 914 (N.D. Ill.), affirmed on other grounds, 409 F. 2d 872 (C.A. 7, 1969).

argument that Section 22 of the Investment Company Act, taken together with the rest of the Act, and with the Maloney Act, constitutes an integrated scheme mandated by Congress for the regulation of the pricing and distribution of mutual fund shares by the Commission, and further, that as part of that integrated scheme the contractual restrictions alleged in Counts II–VIII of the Complaint are authorized by Section 22(f).

C. THE CONTRACTUAL PROVISIONS ALLEGED IN COUNTS II–VIII OF THE COMPLAINT ARE RESTRICTIONS ON TRANSFERABILITY AND NEGOTIABILITY WITHIN THE MEANING OF SECTION 22(f) AND ARE NOT IN VIOLATION OF THE OTHER REQUIREMENTS OF THAT SECTION.

As the Appellant points out in its brief:

> * * * A fund is authorized by Section 22(f) to impose * * * restrictions only if they are fully disclosed in the fund's registration statement, and, in any event, they must not contravene rules and regulations of the Commission.[2]

The Appellant argues, however, that the contractual provisions alleged in Counts II through VIII do not qualify under Section 22(f) because (1) they are not fund-imposed but rather are contractual "agreements between principal underwriters and funds and between underwriters and broker-dealers";[3] and (2) because these contractual agreements involve "restraints of the distribution mechanism rather than restraints on the alienability or negotiability of the

[2] Brief of Appellant at 43.
[3] *Ibid.*

fund shares themselves."[4] Apparently, the only conduct that the Appellant would accept as constituting a restriction on transferability or negotiability within the meaning of Section 22(f) is a restrictive legend printed on a fund certificate at the behest of the issuer.

Underlying the Appellant's argument with respect to Section 22(f) is a presumption against the validity of fund-imposed restrictions on transferability and negotiability. This presumption, however, is inconsistent with the legislative history of that section. As the legislative history discussed above demonstrates, restrictions on transferability and negotiability were imposed by funds to combat a number of practices occurring in the secondary market of their shares which were harmful to investors, including dealers switching investors between funds, the dilution of funds' assets as a result of riskless trading by dealers, and the disruption of the funds' distribution systems with the consequent threat that the funds might be thrown into a net redemption situation.[5]

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[4] *Ibid.*

[5] While the Appellant concedes in a footnote that Section 22(f) was directed to the issues of the bootleg market, Brief of Appellant at 32, n. 22, its only textual discussion of the legislative history of Section 22(f) is the assertion that that section

"* * * was intended to limit the practices of certain funds whose share certificates specified that the shares were not transferable except by redemption with the fund. Quite often those restrictions were not disclosed to investors before they purchased the shares. Because such restrictions deprived the investor of a valuable ownership right, Congress required their disclosure in the registration statement and authorized the Commission to regulate them."

The implication of this legislative history that the drafters of the Investment Company Act considered restrictions on transferability and negotiability consistent with the broad regulatory purposes of the Act is further strengthened by the only significant amendment of the language of Section 22(d)(2) of S. 3580 and H.R. 9835 that was incorporated in Section 22(f). The original section required that the Commission's rules regulating restrictions on transferability and negotiability be "in the public interest and for the protection of investors." (See p. 39, *supra.*) As ultimately stated in the Investment Company Act, however, the Commission's rules under Section 22(f) are required to be "in the interests of the holders of all of the outstanding securities of such investment company." This standard clearly requires the Commission to look to the remedial function of restrictions on transferability and negotiability, as well as to their effect upon competition. Section 22(f) thus bespeaks Congress' endorsement of restrictions on transferability and negotiability subject to Commission regulation.

Brief of Appellant at 44–45.

There is simply nothing in the legislative history cited by the Appellant in support of the above statement supporting its assertion that restrictions on transferability and negotiability were not disclosed. And, in the Senate Hearings on S. 3580 one industry representative testified with respect to restrictions on transferability and negotiability imposed by his funds that:

"* * * When the stockholders of our two funds bought these shares, they knew that they could sell them only to the trusts themselves."

Senate Hearings at 708.

In view of this endorsement by Congress of the remedial purpose of restrictions on transferability and negotiability, it is necessary that Section 22(f) "be construed broadly to effectuate its purpose." *Tcherepnin* v. *Knight,* 389 U.S. 332, 336. The appellant's insistence that the conduct alleged in Counts II through VIII does not fit under Section 22(f) defies this cannon of statutory construction. Thus the appellant's argument that the "contractual restrictions on distribution here involve restraints on the distribution mechanism rather than restraints on the alienability or negotiability of the fund shares themselves"[6] confuses the manner in which these restraints are effected with the question of whether they fall within Section 22(f).

Contrary to the assertion of the appellant prior precedents interpreting Section 22(f) support the view that the conduct alleged in Counts II through VIII does constitute restrictions on transferability and negotiability within the meaning of that section. Soon after the adoption of the Investment Company Act the Commission had occasion to review whether NASD Rule 26, which was adopted to curb many of the abuses noted in the legislative history of the Investment Company Act, complied with the standards of Section 15A(b)(8) of the Maloney Act.[7] Section (j)(2) of Rule 26 prohibited NASD members who are underwriters of a mutual fund from repurchasing mutual fund shares from certain classes of dealers or from any investor unless such persons are the record holders of the securities being repurchased.

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[6] Brief of Appellant at 43.

[7] *National Association of Securities Dealers*, 9 SEC 38.

The Commission characterized this section as a "restriction upon the transferability of securities" comparable to the restrictions dealt with in Section 22(f).[8] Similarly, the Appellant itself, in testimony during the Commission's hearing on repeal of Section 22(d), has asserted that fund-imposed requirements that only owners of record may redeem their shares and that actual delivery of shares must precede redemption are restrictions on transferability within the meaning of Section 22(f).[9]

These precedents reflect Congress' intention to regulate, through Section 22(f), restrictions on secondary market activities in mutual fund shares. Counts II through VIII allege a course of conduct intended to restrict the secondary market activity of dealers and underwriters in fund shares. To the extent that these pleaded allegations of the Appellant are true, then such conduct must, by the Appellant's own definition, involve restrictions on transferability and negotiability within the meaning of Section 22(f).

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[8] 9 SEC at 44–45, n. 10.

[9] Comments of the United States Department of Justice, Mutual Fund Distribution Hearings (File No. 4–164) (February 2, 1973) at 14 citing Staff Report at p. A–58. *See also*, Testimony of Daniel Hunter, trial attorney for the Appellant in this case, *id.* at 2089–2090. The appellant's present argument, that Section 22(f) refers only to restrictions on the face of a fund's shares, Brief of Appellant at 43, is based on its attempt to raise Mr. Schenker's example of a restriction on transferability and negotiability, given in his Senate testimony on Section 22(d)(2) of S. 3580, to the dignity of the exclusive conduct covered by that section. *See* Senate Hearings at 292. In this connection, it is worth noting that the example of a restriction on transferability intended to curb bootleg market activity which is referred to in the Investment Trust Study, involves a restriction contained in the fund's prospectus rather than one

The Appellant also argues that Section 22(f) only authorizes fund imposed restrictions on transferability and negotiability rather than restrictions contained in contracts between underwriters and dealers.[10] But this argument again loses sight of the context in which these restrictions arise. Both the appellant's own brief (Brief of Appellant at 6) and the history of the Investment Company Act recognize that there is usually a close affiliation between a mutual fund and its principal underwriter. Furthermore, Sections 15 (b) and (c) of the Investment Company Act, 15 U.S.C. 80a–15 (b), (c), taken together, require principal underwriters of mutual funds to have a written contract with the fund. Such contracts must be approved by a majority of the fund's disinterested directors and cannot continue for more than two years unless approved annually by the board of directors or by a majority of the shareholders. Also, the principal underwriters who are defendants in this case are required, by NASD Rule 26, to enter into agreements with dealers who distribute their funds. The fund is required to file those agreements with the Commission, as well as the underwriting contract between the

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stamped on the face of its shares. Investment Trust Study, Part III at 865.

[10] This argument, of course, can only be made with respect to the conduct alleged in Counts II, IV, VI and VIII of the complaint since Counts III, V and VII allege fund imposed restrictions rather than underwriter imposed restrictions. Furthermore, it should be noted that the conduct alleged in Count III involves an agreement between Fidelity Fund, a mutual fund, and Crosby Corp., its principal underwriter, to "obligate" Crosby Corp. to enter into the restrictive agreements alleged in Count II, thus making the restrictions in Count II the result of actions by Fidelity Fund. *See also*, Brief of Appellant at 11.

fund and its principal underwriter.[11] In view of these circumstances, and in view of the broad effect that must be given to Section 22(f), where the contractual restrictions alleged in Counts II through VIII have in fact been filed with the Commission by the fund, such restrictions clearly involve the kind of conduct Congress intended to be authorized in Section 22(f), subject to Commission regulation.

D. THE CONDUCT ALLEGED IN COUNTS II THROUGH VIII IS IMMUNIZED FROM ANTITRUST ATTACK BY SECTION 22(f) OF THE INVESTMENT COMPANY ACT

As discussed above, the conduct alleged in Counts II through VIII of the Complaint constitutes restrictions on transferability and negotiability of mutual fund shares which are authorized by Section 22(f) absent Commission rules prohibiting such conduct. Despite the Commission's awareness of the challenged conduct for several decades, it has not deemed it necessary to adopt rules prohibiting such conduct.[12] The Appellant urges, however, that Section 22(f) does not displace the antitrust laws but "merely provides further limitations on a fund's restriction of the transferability of its shares." Brief of Appellant at 44.

This argument ignores this Court's often repeated pronouncement that the antitrust laws will be considered repealed to the extent that they are repugnant to

[11] 1 CCH F. Sec. L. Rep. ¶ 71,777, Item 1 (Form S-5); 3 CCH F. Sec. L. Rep. ¶ 51,296, Item 6 (Form N-8B-1).

[12] The Commission has, however, indicated that in the context of its program to introduce increased price competition in the distribution of mutual fund shares it will, if necessary, exercise its authority under Section 22(f) to prohibit any fund-imposed restrictions on a secondary *brokerage* market. Staff Report at 105, n. 1. *See* p. 23, *supra*.

a federal regulatory scheme. *Silver* v. *New York Stock Exchange, Inc.*, 373 U.S. 341, 357; *United States* v. *Philadelphia National Bank*, 374 U.S. 321, 350–351. Section 22(f) manifests a presumption in favor of restrictions on the transferability and negotiability of mutual fund shares, subject to Commission regulation. But Commission regulation under that section is to be guided by a standard different from the "public interest" standard embodied in other regulatory schemes. While the interests of the holders of all the outstanding certificates of a mutual fund include a right to the protection afforded by the national policy in favor of competition,[13] Congress intended that the prohibition on restrictions on transferability and negotiability not be accomplished at the expense of protection against switching, dilution and disruption of the distribution system. It would nullify the effect of this grant of regulatory authority to the Commission for this Court to hold that a district court may apply antitrust principles to conduct like that alleged in Counts II through VIII, when the expert body designated and empowered by Congress to regulate and supervise that conduct has not heretofore deemed it appropriate to prohibit the conduct.[14]

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[13] *Compare Gulf States Utilities* v. *Federal Power Commission*, 411 U.S. 747; *Federal Maritime Commission* v. *Seatrain Lines, Inc.*, 411 U.S. 726; *Bowman Transportation, Inc.* v. *Arkansas-Best Freight System, Inc.*, 43 U.S.L. Week 4091, 4096–4097 (U.S., decided December 23, 1974).

[14] In order to bolster its argument that Section 22(f) is not inconsistent with the antitrust laws, the Appellant observes that "Appellees have not contended that Section 22(f) preempts state law requirements, [for restrictions on transferability and negotiability] and there is no basis for such a claim." Brief of Appellant at 48. The question of whether the conduct

The repugnancy between the antitrust laws and the regulatory scheme here involved is particularly evident in the present lawsuit. It is undisputed that the contractual agreements alleged in Counts II through VIII have been filed with the Commission pursuant to the Investment Company Act. Furthermore, the record of this case,[15] and the public record,[16] reflect that the Commission and the Commission's staff have been personally aware of these restrictive provisions and have not taken action to eliminate them. Further, as noted above, in its program for introducing retail price competition into the mutual fund industry the Commission has determined not to take the precipitous action requested by the appellant in this lawsuit. The Commission has determined to eliminate, initially through NASD rules, contractual agreements which inhibit secondary brokerage transactions in fund shares. But in requesting the NASD to take this action, the Commission made clear that

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challenged in Counts II through VIII can be characterized as restrictions on transferability and negotiability within the meaning of state law, and what effect Section 22(f) would have on state law if such a characterization were appropriate, is simply not before this Court. That conduct does fall within the meaning of Section 22(f), however, and as such, is immune from federal antitrust attack so long as it complies with the requirements of that section.

[15] *See* Exhibit 16 to Affidavit of Daniel R. Hunter in Support of Plaintiff's Memorandum in Opposition to Defendant's Motion to Dismiss, *United States* v. *National Association of Securities Dealers*, No. 338-73 (D.D.C., filed July 16, 1973) (App. 274-275).

[16] *First Multifund of America, Inc.*, Investment Company Act Release No. 6700, CCH F. Sec. L. Rep. ['70-71 Transfer Binder] ¶ 78,209 at 80,602, n. 7; *Mutual Funds Advisory, Inc.*, Investment Company Act Release No. 6932 (1972) at 7 (Dissent of Commissioner Loomis).

> * * * action in this area should also include steps to help to neutralize any adverse impact on the funds' primary distribution systems and to insure that transactions in a brokered market are in the interests of all of the holders of the funds' outstanding shares.[17]

Similarly, the Commission's Staff Report indicated that it would approach cautiously the introduction of a secondary non-contract dealer market during its program to introduce retail price competition into the mutual fund distribution system. The direct result of the inter-dealer market which the appellant seeks to introduce through this lawsuit, however, would be to encourage the development of such a non-contract dealer market which would compete with the funds' primary distribution system.

The appellant's prayer for relief simply does not reflect any concern for these policies of the Investment Company Act.[18] The granting of the appellant's prayer

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[17] Letter from Ray Garrett, Jr., Chairman, Securities and Exchange Commission to Mr. Gordon S. Macklin, President, National Association of Securities Dealers, Inc., dated November 22, 1974. Chairman Garrett further explained:

"* * * For example, funds would be permitted to impose reasonable service fees when ownership of their shares is transferred in this manner. In the absence of any underwriter's spread on the sale, such fees could include the cost of recording the transfer as well as an amount to compensate the underwriter, to some extent, for promotional services. To ensure that broker-dealers engage only in the genuine matching of orders, they should not be permitted to fill orders to buy or sell fund shares more than one full business day after such orders are received. Nor should broker-dealers be required to set up special procedures to match orders for fund shares."

[18] *See* Complaint at 20–22 (App. 18–19).

for relief would be inconsistent with a regulatory judgment of the Commission and would interfere with the Commission's program. Any review of the Commission's action should not occur under the inappropriate standards of the antitrust laws.[19] Rather the Commission's judgment should be considered under the standards of the acts which it administers.[20] Otherwise the authority of the Commission "to conclude that preservation of a competitive structure in a given case is overridden by other interests,"[21] would be meaningless.

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[19] Under Section 4(d) of the Administrative Procedure Act, 5 U.S.C. 553, any interested person may petition an administrative agency for the issuance, amendment or repeal of any rule of that agency. And Section 10(d) authorizes a federal district court to "compel agency action unlawfully withheld or unreasonably delayed." 5 U.S.C. 706.

Moreover, Section 10(a) of the APA, 5 U.S.C. 702, generally affords judicial review to persons "adversely affected or aggrieved by agency action within the meaning of a relevant statute * * *," as well as to any "person suffering legal wrong because of agency action." *See Independent Broker-Dealers' Trade Association* v. *Securities and Exchange Commission*, 442 F. 2d 132, 141–143, *certiorari denied*, 404 U.S. 828 *cf. PBW Stock Exchange, Inc.* v. *Securities and Exchange Commission*, 485 F. 2d 718, 726, 733 (C.A. 3), *certiorari denied*, 416 U.S. 969.

[20] McLean Trucking Co. 1. United States, 321 U.S. 67, 79–80, 85–88 (Interstate Commerce Commission). *Cf.*, *California Gas Producers Association* v. *Federal Power Commission*, 421 F. 2d 422, 428–29 (C.A. 9), *certiorari denied*, 400 U.S. 819; *Cities of Statesville* v. *Atomic Energy Commission*, 411 F. 2d 962, 987 (C.A. D.C.. (Leventhal J. concurring); *Northern Natural Gas Co.* v. *Federal Power Commission*, 399 F. 2d 953, 961 (C.A. D.C.).

[21] *Bowman Transportation, Inc.* v. *Arkansas-Best Freight System, Inc.*, 95 S. Ct. 438, 448.

It is therefore evident that, to the extent that the contractual restrictions alleged in Counts II through VIII of the Complaint have been filed with the Commission as part of fund registration statements under the Investment Company Act, those restrictions are immunized from antitrust attack by the regulatory scheme of mutual fund distribution embodied in the Investment Company Act, and in particular by Section 22(f) of that Act. This antitrust immunity does not apply to all conduct of mutual funds or even to all contractual agreements between mutual funds, their principal underwriters, and dealers. But within the context of the pervasive scheme of regulation of investment company activity administered by the Commission, Congress intended that in the narrow area of restrictions on transferability and negotiability of mutual fund shares, the competitive principles of the antitrust laws would be tempered with protection against secondary market transactions by dealers involving dilution of fund assets, unfair switching of investors between funds, and disruption of fund distribution systems. Application of the Sherman Act to conduct subject to this regulatory scheme would frustrate the goals of Congress in establishing that scheme.[22] Accordingly, consistent with this Court's past pronouncements, the antitrust laws should be considered impliedly repealed as to conduct clearly subject to the Commission's jurisdiction under subsec-

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[22] *Compare Baum* v. *Investors Diversified Services, Inc.*, 286 F. Supp. 914 (N.D. Ill.), affirmed on other grounds, 409 F. 2d 872 (C.A. 7).

tion (f) of Section 22 of the Investment Company Act of 1940.[23]

CONCLUSION

For the reasons stated, the judgment of the district court dismissing the complaint should be affirmed.

Respectfully submitted.

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Securities and Exchange Commission.

I authorize the filing of the foregoing brief.

ROBERT H. BORK,
Solicitor General.

JANUARY 1975.

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[23] *Compare Hughes Tool Co.* v. *Trans World Airlines, Inc.*, 409 U.S. 363, 385, n. 14; *Pan American World Airways, Inc.* v. *United States*, 371 U.S. 296.

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